DOW THEORY LETTERS INC.

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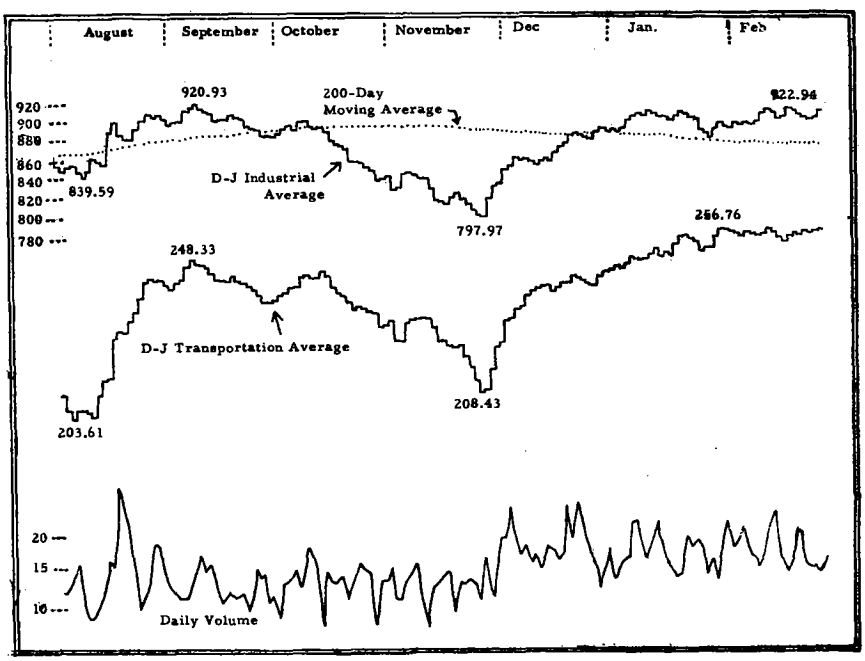
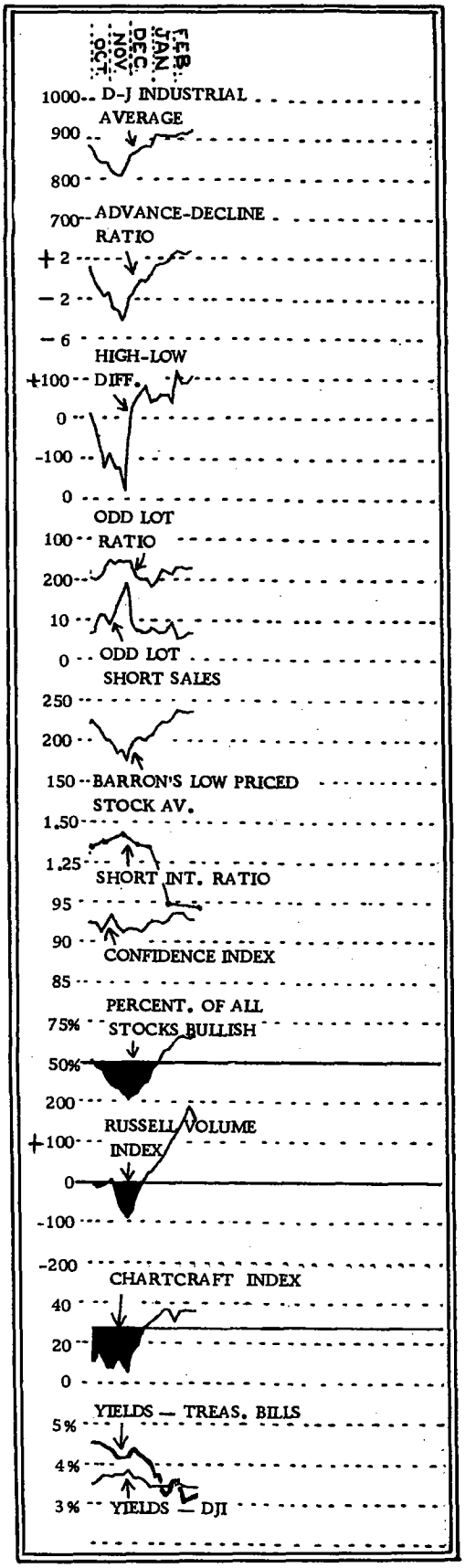
Standby devaluation power to let the President agree to a further gold price rise could be "useful," Treasury Under Secretary for Monetary Affairs Volcker told the Senate Banking Committee. However, he urged the panel to keep such features out of the administration's 8% devaluation bill.

STRANGE-REQUEST-OF-THE-MONTH DEPT: Under-Secretary Volcker ("Mr. I hate gold" himself) undoubtedly wins this month's title hands down. Is he scared of what he sees in the free gold market? Does he see the handwriting on the wall? Is he "advance man" preparing for a total Administration reversal on the gold policy? Who knows, but here is the incredible news clip from February 23rd's Wall Street Journal.

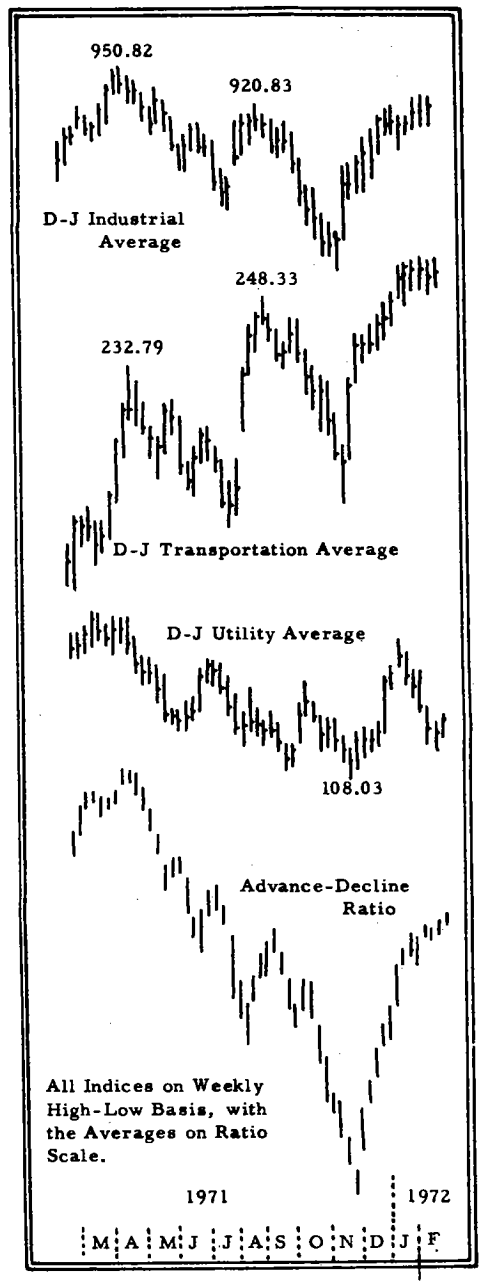
THE PICTURE: President Nixon has promised the American people "a surprise a month" right up to election time, but novelties and surprises are no guarantee of optimism or prosperity. In fact, the American people are now saving their pay at the rate of 8.2% the highest rate since 1946, and Administration spokesmen are complaining about this "lack of faith in the economy". February's surprise is Mr. Nixon's China trip, and aside from the more obvious targets of good-feeling between China and the U.S. (which I certainly approve of), I gather that there will at least be an attempt at an historic "deal". For instance, China produces nothing that the U.S. really needs, but she does need U.S. capital goods. That means that China needs U.S. trade credits. And the U.S. needs (or hopes for) Chinese "muscle" to end the war in Vietnam. And in those joint needs could be the seeds of a deal (assuming China can produce a Vietnam peace, which I personally doubt).

Meanwhile, the strain between the U.S. and its overseas creditors continues unabated, and the erosion in value of the dollar also continues without respite. The demise of the dollar is filling Europeans with dread, since they hold upwards of $60 billions of the greenbacks. So far, Europeans have been supporting the dollar via buying operations, but this practice cannot go on indefinitely. If Europeans let the





dollar "float" again, it would amount to a further revaluation (i.e., pricing up) of their own currencies. But there is one rather giant problem. As economist Eliot Janeway puts it in his latest Service, "The dollar-holding powers now need a devaluation (underline mine) at least as big as they have just blundered into giving the dollar. The devaluation they need would help them, where it has not helped the dollar. Nevertheless, it's the dollar which is threatened with another devaluation; while the dollar-holding powers are threatened with another revaluation....A new dollar crisis is building up as the 'Smithsonian' deal comes apart. Where the first devaluation did not help America, a second would hurt it...."



Perhaps most disconcerting (thanks to William Tehan of Herzig & Co. for this information) is that some nations are now turning in their dollars (India, Libya, etc.), and this means more greenbacks to absorb by the central banks who are the U.S.'s creditors. My own feeling is that the stock market is now bracing itself for another monetary crisis which will probably come well before the end of 1972. So far, what we see, as Wall Street's most acute minds attempt to appraise the situation, is huge trading volume with much "churning", much selling of high-grade equities and a great deal of speculation in the "cats-and-dogs" by people who obviously could not care less whether the dollar survives or whether gold goes to $100 or $1000 an ounce.

The steady inroads of inflation are working cruel hardships on Americans in general, and on savers and holders of fixed income instruments in particular. It appears to me that people would like to find a "safe haven" or hedge against our Government's profligacy. They would like to think that common stocks fulfill the need for a hedge, but mere wishes will not, and never have, held up the stock market. The only factor which will move stocks up and hold them there is rising earnings, and there's the rub.

The fact is that the forthcoming earnings picture is anything but clear. The West Coast dock strike has been settled, which means the flood of foreign cars will begin again. And foreign technology and competition is proving an increasingly vicious force for U.S. manufacturers to contend with. Then there is the major problem of the U.S. budget being totally out-of-control, which means a huge question mark regarding the trend of bonds and interest rates during the rest of 1972 and 1973.

That the Averages have a difficult problem to contend with can be seen in their profile since the 1st of the year. The Industrials closed the first trading day of 1972 at 889.30. By January 17 the Dow reached a temporary peak of 917.22. A decline ensued, and by January 26 the Industrials had receded to 889.15, exactly 15¢ below their first-day closing. A new advance began, and on February 16 the Industrials reached a high for the year at 922.94. This represented a gain of only 3.5% from the opening trading day of 1972.

From the standpoint of Dow Theory, I would consider a joint bettering of 922.94 (Industrials) and 256.76 (Transports) as a bullish signal and an indication of higher prices to come. Conversely, I would consider a violating of 889.15 and 252.12 as a bearish signal and an indication of lower prices to come.

The page 2 chart (weekly postings) shows the continuing divergences in the leading indicators with the Transports well above their April, 1971, high, the Industrials below the April, 1971, high, and the Utility Average still flirting with its 1971-72 low. Meanwhile, the A-D ratio has made up only about half the losses since the April, 1971, high. Such an "out-of-gear" picture usually indicates distribution. Here we see the two higher-grade Averages, Utilities and Industrials, acting weaker than the Transports, which represents the speculative Average. Volume is running a record level, also suggesting much churning and distribution.

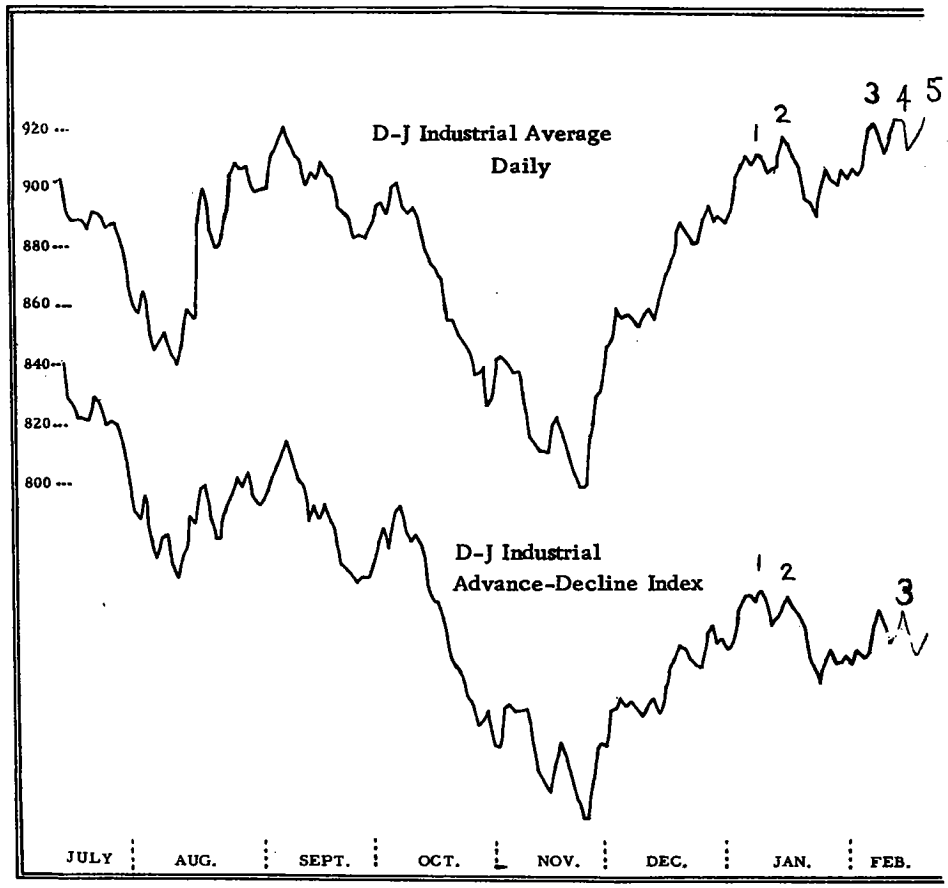
One factor should be discussed here, a factor which I have not mentioned before. I just spoke to a gentleman who I consider one of the shrewdest and most intelligent men in the West regarding the market, economics and politics. He told me, "This market and the economy is being held together with strings. Washington is trying to hold it up until the election is out of the way. After that, watch out. Interest rates could be rising, you could have exchange controls, labor wants restrictive trade controls, foreign competition could, and in all likelihood, will get even more vicious. The plugs will be pulled. The smart

money in Wall Street is well aware of the after-election possibilities, and they will most likely try to jump the gun. I see signs of heavy distribution here, and I don't like it at all. So I am watching for Wall Street to jump the gun on this whole thing, and that means trouble before and probably well before election time".

And that, I feel, is the way a great many very sound minds are thinking — and acting.

DOW ADVANCE-DECLINE INDEX:

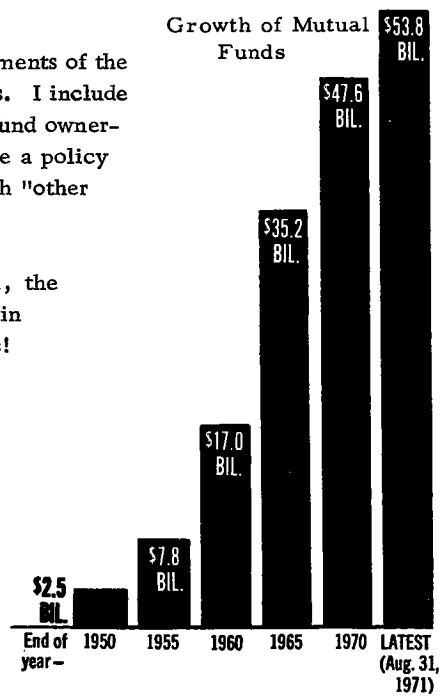
Up-dating the A-D Index on the 30 Dow Industrial stocks (see the last report) provides a most interesting picture. The accompanying chart is worth studying. Here we see five successive ascending peaks of the Dow, and they are numbered accordingly. At the same time, we see three descending peaks on the Dow A-D ratio.



Thus the divergence which began in mid-December, 1971, seems to be continuing. Of particular interest, I thought, was the action of Friday, February 25. On that day with the Dow Industrials up 10.09 points (DuPont was up 6½ points on that day and accounted for a large part of the rise), the Dow A-D Index showed a rise of only 7. This was certainly a weak showing, considering that we have had many readings of plus 22 and plus 23 on really strong days.

At any rate, the chart shows how the picture now stands, and it remains to be seen whether the divergence will be wiped out by a surge to the upside on the Dow A-D Index, or whether the Index is saying that trouble is building up in the continuing divergence between a stronger Dow Average and outstanding weakness in the breadth of the Dow on the upside.

NEW MARKET: One of the reasons for the relentless straight-up and straight-down movements of the market since the mid-1960's is the phenomenal rise of ownership by institutions and funds. I include a chart showing the rise in mutual funds assets since 1950. This incredible rocketing in fund ownership is all the more significant when we realize that the great majority of these funds have a policy of being heavily committed in common stocks and that they are all making decisions with "other people's money".



As if the rise in mutual funds is not incredible enough, we turn to the newer phenomenon, the pension funds. It is estimated that corporate pension funds now have about $135 billions in assets, and that union, state and city pension funds control another $100 billions in assets!

The pension funds have been moving steadily towards higher positions in common stocks, and the corporate pension funds now have about 40% of their assets in common shares. Thus we have the picture of funds of all types owning better than $200 billions in common shares, and this is a force to reckon with.

In the meantime, veteran market observers are warning about the exit of the individual investor. This means an impairment of liquidity, and it means that more and more the exchanges are simply places where large interest swap large blocks of stock as if they were dealing with odd-lots. So far, the institutions have been able to get away with this type of action, although there were times

during the 1969-70 collapse when it seemed as if there were no bottom to the market. Certainly the breadth figures during 1969-70 (i.e., advances and declines) showed the worst downside compression since the 1929-32 crash.

My own feelings is that there is now even less liquidity than there was during 1969-70. When this market turns down and the bear takes over, I expect to see the most persistent, the most vicious and the most costly smash in stock market history. Meanwhile, there are many signs that the market is under distribution now, but this could be a long, drawn-out process. I feel that distribution for this rise began in earnest in mid-December, 1971.

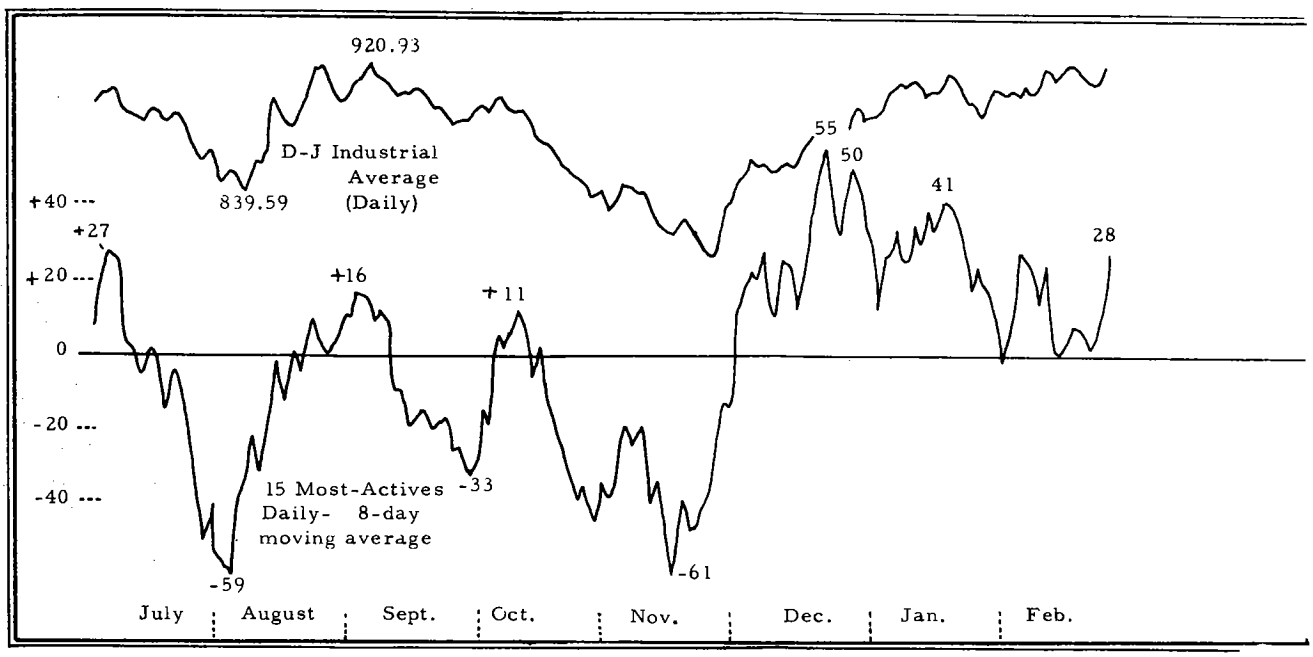
MOST ACTIVES: In the last Letter I reviewed the Weekly "Most-Active Stocks" Index. I noted that the most-active stocks usually account for about 15% of total N.Y.S.E. volume, and that the direction of the Most Active Index usually leads or coincides with the direction of the general market.

Back in Letter 509 I introduced my new daily Index of the Most-Actives based on an 8-day moving average. This Index was reviewed in Letter 513, and I am up-dating that study in this Letter.

The Index is very simply computed. Each day I compute the plurality of pluses or minuses in the 15 most-active stocks. If there were 10 advances and 5 declines, the daily figure would be plus 5. Then these daily figures are plotted in the form of an 8-day moving average. What is looked for is divergences, and since mid-December there have been a long series of divergences. For the record, I have listed the series of four ascending peaks on the Dow Industrials (closing basis) and the five descending peaks in the Most-Active Index.

	Index	Dow closing
Dec. 21	55	888.32
Dec. 28	50	893.68
Jan. 18	41	917.22
Feb. 25	28	922.79

This is one of the most persistent series of divergences that I have seen on the Most-Active Index, and it suggests steady distribution in the most-active stocks since mid-December, and most probably steady distribution in the rest of the market. All of this distribution has occurred under the guise of an Industrial Average which has been creeping higher, even though the entire range for the Dow since 1972 has been only 34 points.



GOLD: On July 16, 1971, (Letter 501) I began the regular publication of the gold and silver chart as seen on page 6 of this report. At that time the gold bullion price was in the $42 per ounce area, but I wrote: "It has been said that stock market expertise is more art than science...At any rate my 'artistic instinct' (some refer to it as a 'seat-of-the-pants' instinct) tells me that it is time to add another regular feature to Dow Theory Letters. With this issue I am including a chart of the spot price of silver and gold...Note that the price of gold is now on the move, and although interest in gold shares is currently

minimal, the gold price is now heading for the June peak. If we better the June peak, it would not surprise me to see gold head for the $44-45 per ounce level."

And so it did, as you can see by the current page 6 chart. Almost every Letter since 501 has included the updated gold chart plus some comments on the gold price. I consider the price of gold to be a critical thermometer of the U.S. economic condition, and right now the patient is running a burning fever. For despite the currency alignments and despite the absurd U.S. devaluation which will move gold from $35 to $38 per ounce, it is requiring massive purchasing operations by overseas central banks to keep the dollar from literally caving in. Or as one famous overseas news service put it last week, "U.S. authorities are openly 'daring' the foreign central banks to stop buying all the dollars that people choose to foist on them and just let their currencies appreciate further so as to give the dollar even more trading advantage than did the December devaluation...." This same source, which was optimistic in December, now refers to "the Smithsonian mock-settlement", and "the essential quackery of the Smithsonian agreement".

Last week I was most interested to see famous Dow Theorist Mr. E. George Schaeffer write about the price of gold in his new service "Stocks, Bonds, Real Estate and Money" (910 E. 38th St., Indianapolis, Ind. 46205). Schaeffer wrote: "I have studied the Dow Theory and the Averages for over 40 years, and I have made many technical improvements in that Theory over the years, for all to see. Many other analysts have followed my leadership and suggestions. Right now, however, and for the next several years, I will put a great deal more emphasis on an area I have seldom even mentioned during my first 37 years of study and experimenting. A new indicator is rising — and that is the 'price of gold in the world's free markets' — which I consider more important than today's manipulated DJIA or the DJTA. Only the DJUA is telling the truth — it has been 'going down' for 7 years, and it's predicting a depression ahead. The rising price of gold is one of our very best indicators today. By going to new highs, irregularly, it is telling us that monetary problems are ahead, and that we may very well witness a major depression in 1973, 1974, and 1975."

Washington, having taken a beating on the international monetary front and having had to eat its words on "no devaluation," is now being a bit more careful. Treasury Secretary Connally has warned Europe that there can be no dollar convertibility until there is substantial improvement in the U.S. balance-of-payments. William Eberle, meanwhile, (see news clip) told a Danish news conference that there would not be any "real progress" on the BOP until the end of 1974! At almost the same time it was announced that the 1971 BOP deficit for the U.S. was $29.6 billions, more than three times all the available gold reserves of the U.S.

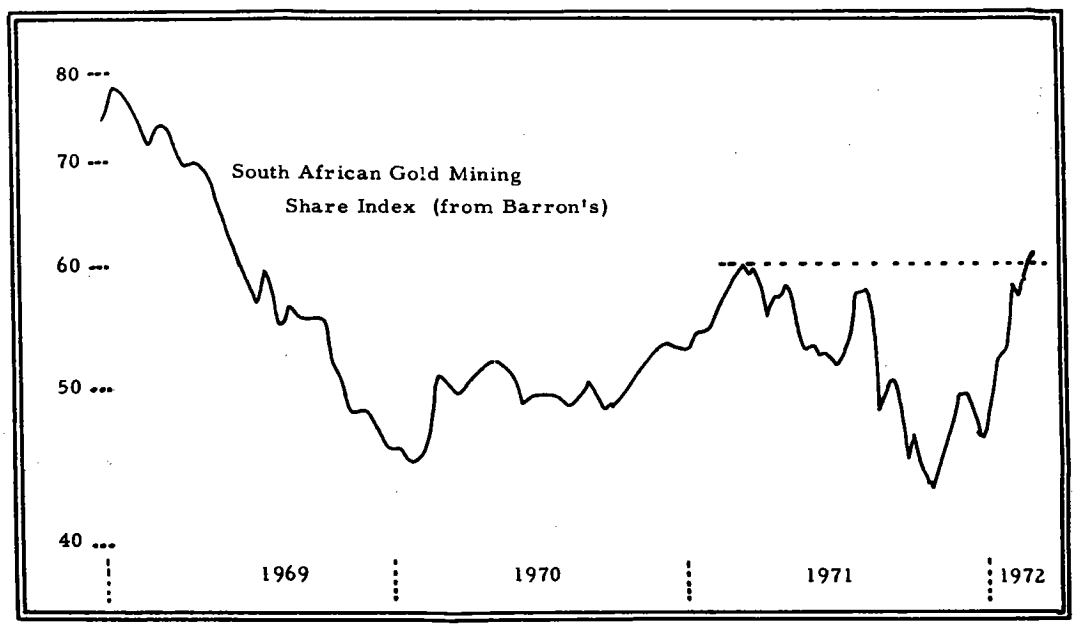
It would seem a matter of time before our overseas creditors, besieged by a flood of new deficit dollars, will erect exchange controls to protect themselves from being bought up by a currency which grows more worthless with each passing week.

Again, my conviction is that it is not the currency alignments or anything else which will measure the direction of the tides of the U.S. economy. It is the value of the dollar, as measured by the price of gold in terms of dollars (i.e., the London dollar price of gold) which will be the key indicator during the period ahead.

COPENHAGEN (DJ)— William Eberle, President Nixon's special representative on trade matters, warned Friday not to expect an early return to free convertibility of the U.S. dollar into gold.

Eberle, here for talks with Danish Prime Minister, Jens Otto Krag, told a press conference that a return to free convertibility doesn't make sense during the present period of U.S. trade deficits.

"The turnaround in the U.S. trade picture will not come quickly," he said. "We won't see any real progress until the end of 1974."



A few more comments regarding gold are warranted at this time. First, industrial usage of gold is running higher than most people suspected. Between 1960 and 1970 industrial gold usage jumped from $400 million to $1 billion. Up 150%. And as pointed out in the latest Holt Investment Advisory, most gold users (including the military, which is now a big user) do not use large enough amounts of gold in any single item to warrant even looking for a possible cheaper substitute. Furthermore, the unique properties of gold almost eliminate a really good substitute. Finally, recent estimates show that by 1973-74 industrial usage will take up all the non-Communist world's annual production of gold.

The public and most of Wall Street does not understand gold, nor does it disbelieve our Government's continuous denouncements of the yellow metal. But the time is drawing near, I believe, when because of inflation and Government hypocrisy, but mainly because of the rise in price of the metal itself, the public and the professionals will start coming in. As in all bull markets, I would say that the first gold shares to move would be the better known listed shares such as Dome Mines, Campbell Red Lake, Homestake and American South African Investment Trust. Once these shares are bid up and over their all-time highs, I would expect the public to start nibbling at the lesser-known and more speculative gold equities. Finally, as the price of gold advances and as the earnings of gold shares march higher, there should be a frenzy to get into gold mining equities of all kinds. This (it seems to me) is the area where we should sell out and turn to greener fields.

Incidentally, many of you may have noticed the ad in the February 21 issue of Barron's for International Investors, Inc, which advertised itself as "an American fund concentrating in gold mining shares." I know nothing about it, but I thought the ad most interesting. The fact is that few mutual funds now hold any gold shares at all, but this too could change in the year or so ahead. Furthermore, with most gold shares being "thin" issues, the entrance of a fund or a few funds into the gold arena could also send the gold shares upwards.

I am including my own chart of the South African Gold Mining Index (Barron's) over the past three years. As you can see, this index is pushing to a 1970-72 high, and I believe this is most significant. A back-off here would give the Index the appearance of a "head-and-shoulders" bottom, but at times when a movement is very strong the "right shoulder" will not even wait to be formed. A push well out of the 60 level would send the Barron's Gold Index heading for its 1969 high. I consider the base which has been formed by this Index capable of sustaining a major upward movement, with or without a further dip and consolidation over the month or two ahead.

GOLD-SILVER: The regular gold and silver chart on this page shows gold over $48 and moving into the area to test its record $49.25 high. The high average price of gold during 1972 should begin to be reflected in rising earnings for gold mines the world over. Silver, meanwhile, continues to mill around its "base" area, and many of the silver stocks are, I believe, long-term investments. Three such are Hecla, Sunshine and Day Mines, all selling far under their old highs. I include a P & F chart from Jim Dines' Crosschart book (18 E. 41 St., N.Y.C. 10017), and note the huge "double bottom at 7.5. I believe the 7.5 low of 1971 was the bottom, and that the beginning of the next major move up for this stock is now in the process.